

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2005 through the Fourth Quarter of 2009

It appears the U.S. economy came through this year's record hurricane season in better shape than had been expected. One of the reasons the economy performed well is because it headed into the fall in such strong shape. For example, real GDP grew at a healthy 4.5% clip (revised up from the preliminary estimate of 3.8%) in 2005's third quarter. Other measures also confirm the economy's strength. National nonfarm employment expanded an average of 198,000 jobs per month from the end of 2004 to August 2005 and the national unemployment rate improved from 5.1% to 4.8% over the same period.

The hurricanes did have impacts on the economy. One the most immediate and widespread impacts was the price of gasoline. Almost over night the price shot above \$3 per gallon after Hurricane Katrina shut down Gulf of Mexico petroleum refineries. Fortunately, the damage has been temporary. Experts expected the price to fall to \$2.50 per gallon by year's end. However, gasoline prices declined faster than anticipated, dropping below \$2 per gallon well before the end of 2005. Nonfarm employment was virtually flat in both September and October, but the employment picture improved in November 2005 with the addition of 215,000 jobs. The national unemployment rate remained below 5% in November 2005. Although official estimates for real GDP in the fourth quarter of 2005 are not available, the expectations for national output have improved. For example, in the previous issue of the *Idaho Economic Forecast*, real output was projected to grow at 2.8% annual pace in the last quarter of 2005. Real GDP is now expected to grow 3% in that quarter.

Beginning in 2006, the negative impacts of the storms of 2005 are replaced with the positive influences associated with the rebuilding efforts. For example, this forecast assumes an additional 150,000 housing starts over the next three to four years to replace units destroyed or rendered uninhabitable by the hurricanes and floods. It has been estimated the government's costs of rebuilding the areas hardest hit by the hurricanes will temporarily delay improvements to the federal deficit. However, this additional spending will boost the economy in the near term. Real GDP is expected to expand 3.4% in 2006, 3.1% in 2007, 3.4% in 2008, and 3.1% in 2009. Consumer price inflation jumped 3.4% in 2005 because of surging energy prices. Eventually energy prices will recede and inflation will once again drop below 3%. With the economy once again on solid ground, the nation's central bank will continue raising the federal funds rate in 25-basis point increments through the first half of 2006. The forecast also assumes the existing home mortgage interest rate will rise from 5.9% in 2005 to 7.3% in 2009. The higher interest rates contribute to the gradual decline in U.S. housing starts from 2.1 million units in 2005 to 1.7 million units in 2009.

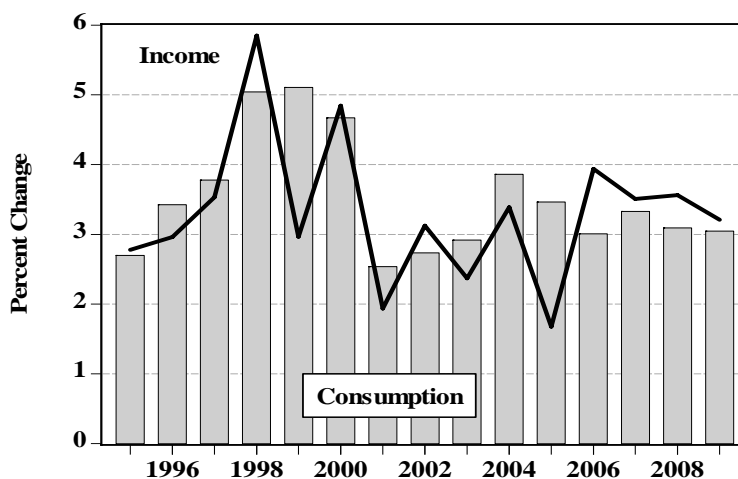
Although the U.S. economy is not expected over the forecast period to replicate 2005's strong showing, growth during the four years following 2005 should be stronger than in the four years preceding it. For example, real output growth averaged 2.3% from 2000 to 2004. It is forecast to be 3.3% over the 2006-2009 period. Employment and real personal income also grow more rapidly in the end of the decade than in the beginning. While the predicted economic growth is not spectacular, it will be respectable.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: Real consumer spending should provide less of a boost to the economy than it has in the recent past. This is a significant change. In each year from 2000 through 2002, real consumer spending grew at least one percentage point faster than real GDP. Thanks to the strong spending, the 2001 recession was mild by historical standards. The gap between spending growth and output growth began to narrow as the current expansion took off. However, after posting gains of 3.9% in 2004 and 3.5% in 2005, real consumer spending is expected to downshift to 3.0% in 2006 in response to rising interest rates and the cooling housing market. The first

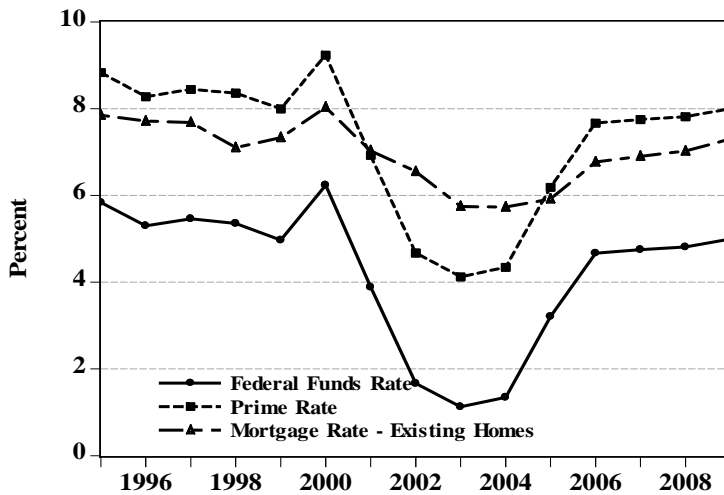
signs of slower spending were actually expected in the last quarter of 2005. After growing by 3.9% annual rate in last year's third quarter, real spending was estimated to move just 0.1% in the last quarter of 2005. This pause in spending is due to the sharp drop-off in light-vehicle sales following the end of automakers' recent "employee discount pricing" marketing campaigns. It is anticipated light-vehicle sales will drop from an annual rate of 17.9 million units in the third quarter of 2005 to 15.7 million units in the last quarter, with light trucks accounting for most of the drop. On an annual basis, light-vehicle sales are expected to fall from 16.8 million units in 2005 to 16.5 million units in 2006, its weakest showing since 1998. Market saturation is another concern for the automotive sector. From 2001 to 2005, the stock of vehicles has risen 2.2% annually, which is much faster than the 1.2% growth of the driving-age population. Car companies are not taking this situation sitting down, and have already implemented their latest incentive programs. Light vehicle sales should gradually recover after 2006 in response to rising real incomes, but it will be 2009 before total sales surpass their previous cyclical peak of 17.3 million units. Near-term consumer spending will be impacted by household budgets stretched thin by rising energy costs. It has been estimated the share of household disposable income spent on energy will climb to a two-decade high of 5.9%. The price of gasoline has retreated from its post-Katrina peak, but persistently high natural gas prices will cause sticker shock this winter. The share of disposable income devoted to energy should decrease as the oil and natural gas supply situation eases over the next three years. The cooling housing market will also limit consumer spending. Consumers have been willing to save less (and spend more) because rising housing prices served as a kind of savings account that grew without making deposits. Consumers also tapped into their home equity in order to finance their recent spending spree. The forecast of slower housing appreciation suggest this source of financing has run its course. After years of adding debt and emptying their savings, consumers will have to live within their means. As a result, real spending is expected to grow more in line with disposable income than it has in the recent past. Real disposable income is anticipated to increase 1.7% in 2005, 3.9% in 2006, 3.5% in 2007, 3.6% in 2008, and 3.2% in 2009. Real consumer spending should grow 3.5% in 2005, 3.0% in 2006, 3.3% in 2007, 3.1% in 2008, and 3.0% in 2009.

U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

Selected U.S. Interest Rates



Source: Global Insight

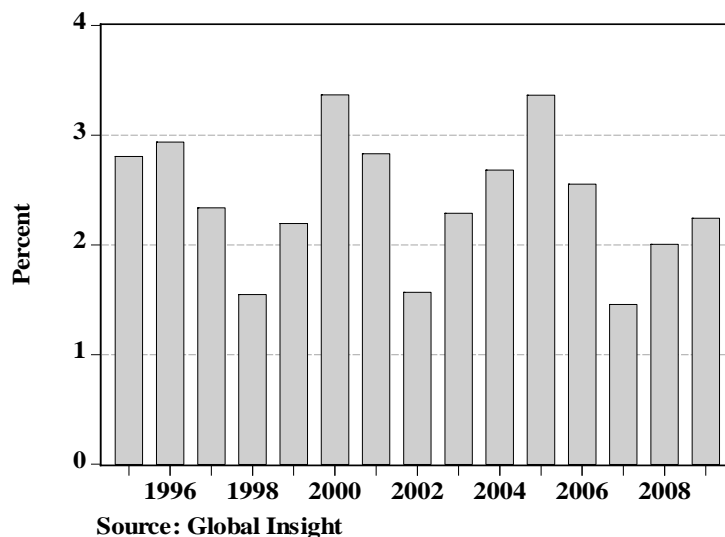
Financial Markets: President Bush appointed Ben Bernanke to replace outgoing Federal Reserve Chairman Alan Greenspan. It is assumed Bernanke will be confirmed by the Senate and start his new job on February 1, 2006. Will the changing of the guard at the central bank bring a change in monetary policy? Not likely. Bernanke and Alan Greenspan are more similar than they are different. Both are “big idea” people who are not afraid to question the conventional wisdom. For example, Greenspan was an early convert to the “new economy” and was quick to recognize the productivity boom of the 1990s. Bernanke identified the risks of deflation in late 2002. More recently, he suggested the global savings glut was the

reason for Alan Greenspan’s conundrum of low long-term interest rates despite rising short-term rates. With respect to monetary policy, both men believe the Federal Reserve should be flexible, activist, and gradualist. Importantly, both believe the Federal Reserve should not take pre-emptive actions against bubbles, but, instead, should be aggressive in damage control after the bubbles have burst. Although the outgoing and incoming chairmen agree on many things, they do not agree on everything. Perhaps the biggest difference of opinion between the two is over inflation targeting. Bernanke is an advocate of explicit inflation targeting. Alan Greenspan believes setting explicit inflation targets are not a good idea because they could limit the flexibility of the Federal Reserve. While explicit inflation targeting by the Federal Reserve is unlikely (given it would require an act of Congress), the incoming Chairman is likely to encourage the Federal Open Market Committee to be open about its implicit inflation targets and more transparent about how it chooses to achieve those targets than the outgoing Chairman. Given the strength of the economy and increasing concerns about creeping inflation, it is assumed the Federal Reserve will continue raising its bellwether federal funds rate in 25-basis points increments to 4.75% at the end of March 2006, before taking an extended pause. The Federal Reserve is expected to adjust the federal funds rate upwards by an additional 25 basis points in late 2008, and it will remain at 5.00% for the remainder of the forecast. The rising interest rates may help slow the U.S. dollar’s recent decline, but it will not reverse it because of the heavy downward pressure from the nation’s huge trade deficit. Specifically, the greenback is forecast to fall 2% in 2005, 2.5% in 2006, 6.0% in 2007, 3.6% in 2008, and appreciate 2.1% in 2009. After averaging just below 6% for nearly three years, the 30-year fixed mortgage rate is expected to move upwards to 7.3% by 2007.

Inflation: The inflation outlook has improved slightly. Short-term inflation fears were calmed in late 2005, as crude oil and gasoline prices retreated faster than had been anticipated from their post-hurricane spikes. In addition, recent strong productivity and the decline in unit labor costs have raised hopes that prices will increase slower. The price of crude oil dropped below \$60 per barrel and the price of unleaded gasoline declined to around \$2.25 per gallon by late November 2005. In an earlier forecast the price of gasoline was assumed to be around \$2.50 a gallon at the end of 2005. The lower gasoline price is the result of emergency supplies of oil and refined products from abroad. Unfortunately, natural gas prices are expected to remain high because of reduced production caused by last year’s storms. According to the Minerals Management Service, as of November 10, 2005, 40.2% of daily natural gas production in the Gulf of Mexico was shut down. The cumulative hurricane-related production losses are nearly 12% of the Gulf of Mexico’s annual production. With the impact of the production losses in

the Gulf of Mexico and the stronger winter demand for natural gas, the price of natural gas at the end of 2005 should be about 90% above last year's price. Residential natural gas heating costs are expected to jump about 50% this heating season compared to last year's heating season. However, if the winter of 2005-2006 is colder than normal, natural gas prices will climb even higher. The good news is energy prices are near their peaks, and they should start declining. The bad news is they will retreat gradually. This can be seen in the forecast for the energy commodity component of the consumer price index. This energy price measure rose 17.8% in 2004 and an estimated 22.6% in 2005. Thereafter, it is forecast to decline 1.8% in 2006, 7.4% in 2007, 3.2% in 2008, and 0.9% in 2009. Despite the near-term pressure from rising energy prices, the overall consumer price index should grow modestly over the forecast period thanks to healthy productivity growth that keeps employment costs growing at around 4% annually. Overall consumer price inflation is expected to be 3.4% in 2005, 2.6% in 2006, 1.5% in 2007, 2.0% in 2008, and 2.2% in 2009. The core inflation rate (all items less food and energy) is projected to be 2.2% in 2005, 2.4% in 2006, 2.5% in 2007, 2.5% in 2008, and 2.6% in 2009.

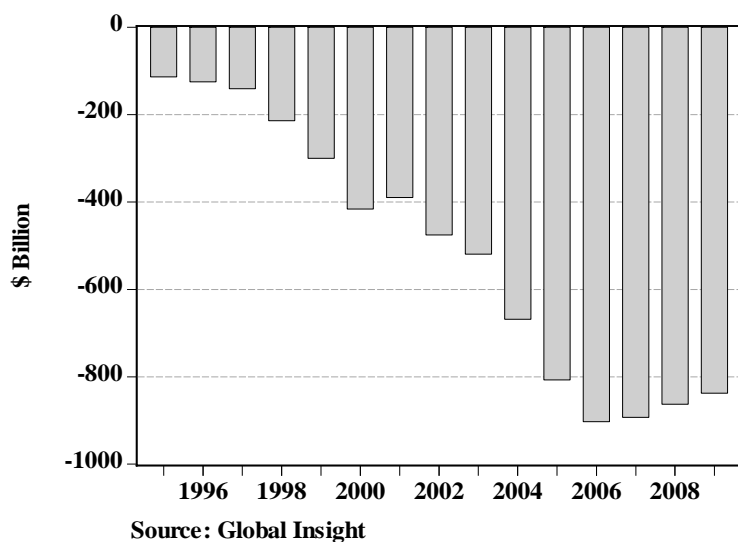
Consumer Price Inflation



International: Global output growth should maintain an above-trend pace through the next few quarters. On an annual basis, real global GDP is expected to advance 3.3% in 2005 and average 3.2% annual growth during the 2007-2010 period. The United States and China should be the two main engines of global activity, as growth in U.S. domestic demand and Chinese production should remain strong. China will be the global economic growth champion. China's economy should increase 9.3% in 2005, 8.5% in 2006, and average 7.5% annual growth from 2007 to 2010. Other developed economies will grow slower than the global pace. Eurozone growth was sluggish during the first half of 2005, and

no marked improvement is foreseen. The region continues to be weighed down by significant economic and political handicaps. As such, real output in the Eurozone is expected to increase just 1.3% in 2005 and 1.6% in 2006, then average 2.0% growth through 2010. The outlook for Japan is brighter than for the Eurozone. The mild upward trend in Japanese consumption, combined with sustained gains in business spending has provided the economy with some much-needed stimulus. Closer to home, the Mexican and South American economies are anticipated to grow faster than the global economy after 2006. Under these conditions, the U.S. trade deficit will grow again in 2006, but will shrink beginning in 2007.

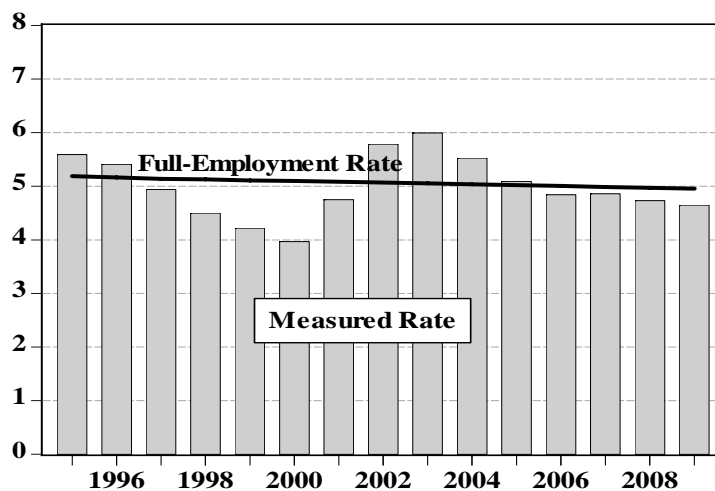
U.S. Trade Deficit



Employment: After a two-month lull, U.S. nonfarm employment increased by a healthy 215,000 jobs in November 2005. This was well above the average monthly job gains of 196,000 for the January-August 2005 period. Battered by the hurricanes that ravaged the Gulf Coast, the U.S. economy eked out just 17,000 jobs in September 2005 and 44,000 jobs in October 2005. The nation's labor market is projected to achieve full employment early in the forecast period thanks to the economy's continuous job production. This a much-welcomed reversal of the situation early in the recovery when dismal job creation caused the unemployment rate to soar. Specifically, the economy experienced no

job gains in 2001 and actually suffered losses in both 2002 and 2003. Not surprisingly, the average unemployment rate jumped nearly one percentage point from 3.97% in 2000 to 4.75% in 2001. The unemployment rate continued to rise even after the 2001 recession had ended, hitting 5.99% in 2003. The job situation finally turned around in 2004, as employment grew 1.1%. This was followed by employment growth of 1.6% in 2005. As a result of 2005's healthy job growth the U.S. unemployment rate declined from 5.4% in December 2004 to 5.0% in October 2005. The unemployment rate is expected to decline to 4.84% in 2006, which is below the full-employment threshold. The labor force is anticipated to remain at full employment for the remaining years of the forecast, as the economy creates jobs at about a one-percent annual pace through 2009. While this is the most likely outcome for the employment, it is not the only one. In one alternative, productivity could soar, energy prices could fall, investment could swell, and foreign economies would be more robust. Under these conditions the unemployment rate would fall to less than 4% by late 2008. Another alternative is one where inflation is high and the Federal Reserve boosts interest rates despite rising unemployment. The resulting stagflation would cause the housing sector to decline steeper than had been forecast. In addition, payroll employment growth would stall in 2006 and 2007, and the unemployment rate would exceed its recent highs.

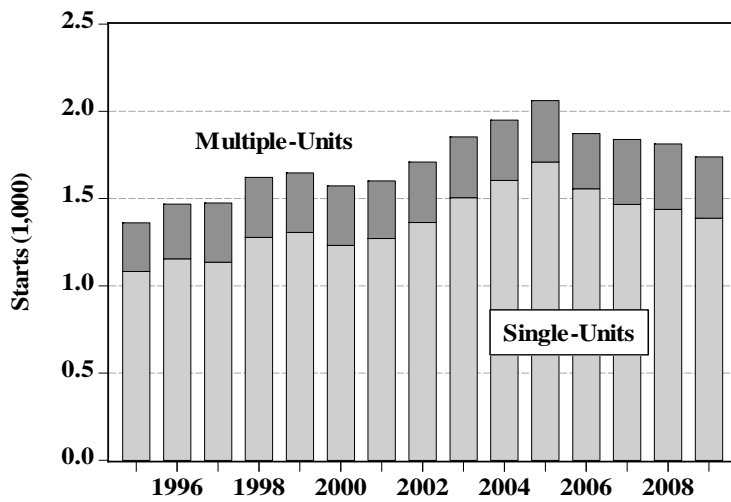
U.S. Civilian Unemployment Rate



Source: Global Insight

Housing: The U.S. housing industry appears to be in transition. Clear signs of strength have been replaced by mixed signals, suggesting this industry may be losing steam. This is an important change because the housing sector has played a major role in propping up the U.S. economy. Industry data from September 2005 show how conflicting the signals have been. New single family home sales rebounded 2.1% last September, but the improvement paled in comparison to the 11.6% decline in the previous month. Average new home sales in August and September were 6% below the second-quarter estimate. More recently, two articles in the *Wall Street Journal* presented divergent pictures of the housing sector. On November 29, 2005 the paper reported the National Association of Realtors estimated sales of previously occupied homes slowed and the inventory of unsold homes grew in October 2005. However, the next day the *Wall Street Journal* published an article describing the U.S. Department of Commerce's findings that new home sales surged in October 2005. The following day the U.S. Department of Commerce reported U.S. construction spending for the first ten months of 2005 was nearly 9% higher than the previous year. Conflicting signals are common when a sector is in transition. Given the housing sector has been red-hot, it means this sector has probably passed its peak. But what a peak it has been. While 1973 set the all-time record for total housing starts, 2005's single-family starts will blow away all

U.S. Housing Starts



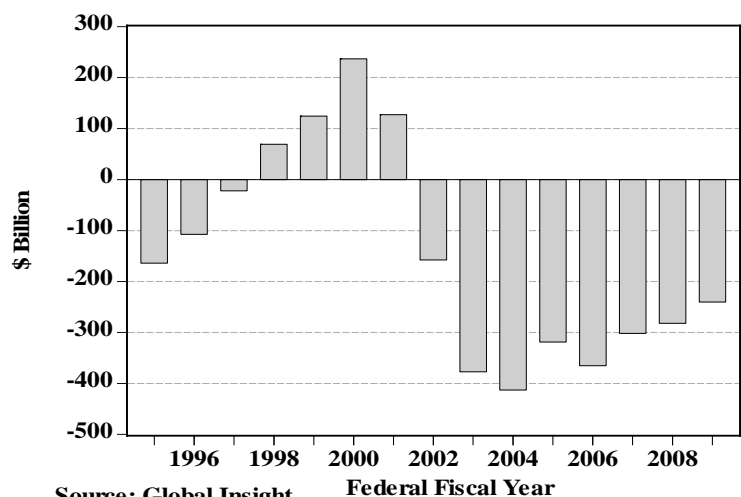
Source: Global Insight

prior records. Single-family starts should reach 1.7 million, which is 6.6% higher than the previous year. Rising mortgage interest rates will make an encore of last year's showing unlikely, however. United States single-family housing starts are projected to be 1.6 million in 2006, 1.5 million in 2007, 1.4 million in both 2008 and 2009. Total housing start are expected to fall from 2.1 million units in 2005, to 1.9 million units in 2006, to 1.8 million units in 2007 and 2008, and 1.7 million units in 2009. The third quarter of 2005 marked the 15th consecutive quarter that residential investment had been a positive contributor to the nation's GDP growth.

It is anticipated that it was also the last quarter it will boost growth for about a year and a half. Fortunately, though, the initial blow from the softening residential sector will be cushioned by the nonresidential construction, whose growth is expected to accelerate from 1.8% in 2005 to 13.6% in 2006.

Government: When President Bush presented his 2006 budget in January 2005, one of his goals was to reduce the U.S. federal budget deficit by half over five years. In order to meet the deficit targets and accommodate higher discretionary spending on defense, extensions of the 2001 and 2003 tax acts, and other savings and health insurance proposals, Congress was asked to cut \$138 billion in discretionary spending and \$68 billion in mandatory programs. While some questioned whether these ambitious deficit targets could be met, a flood of revenue made it clear the spending reductions necessary to meet the President's long-term deficit in 2010 was significantly lower than had been proposed in January 2005. Despite this windfall, little progress had been made on key spending and tax bills by the summer of 2005. The Congress lost the luxury of time in the fall of 2005. The budget and tax reform processes were turned upside down when the August-September hurricanes hit, energy prices spiked, and avian flu hit the radar screen. By mid-November the House had proposed about \$54 billion in total spending reductions and the Senate \$35 billion in spending cuts. With hurricane-related spending projected to bump emergency outlays nearly \$110 billion in the next four years, the proposed spending cuts fell short of what would have been required to keep the deficit under wraps and fund the extensions of the 2001 and 2003 tax reductions. On the Unified Budget basis, the federal budget deficit is projected to be \$319 billion in 2005, \$365 billion in 2006, \$302 billion in 2007, \$282 billion in 2008, and \$240 billion in 2009.

U.S. Federal Government Surplus Unified Basis



Source: Global Insight